CONVERTIBLE NOTES OVERVIEW

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This article was created by Scott Bleier and Elizabeth Resteghini from Morse for Scroobious founders.

Scroobious is increasing diversity in the startup ecosystem by providing the education, tools, and community founders need to create investor-compelling pitch material and a platform to help investors easily find them through data-driven curation. For startup founders who have a story to tell but need help telling it, The Pitch it Plan™, or PiP, is a virtual platform that helps you get your compelling story into an investor-ready format. Unlike googling for hours or paying thousands for a pitch coach, PiP is affordable and approachable through online education and personalized feedback from a human who understands the investor mindset. Our framework has been published, vetted by investors, and has helped founders score meetings, raise rounds, and get into prestigious accelerators. Founders can sign up here or book an intro call to chat.

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Accurately valuing a business enterprise can be challenging. This is particularly true for early-stage, pre-revenue companies with limited operating histories that are seeking to raise seed capital from investors. While many startup company founders will feel that their business is destined to be the next unicorn, potential seed investors may be rightfully skeptical of the company's likelihood of survival (let alone its growth prospects). These differences of opinion can lead to protracted negotiations and introduce friction to the founder-investor relationship. Founders desperate for capital and lacking leverage may ultimately feel compelled to accept a lower than desired valuation for their business, thereby resulting in potentially substantial dilution to the founding team.

Enter the convertible note (and its cousin, the SAFE[1]) which provides a startup company with a means of raising capital while effectively delaying the need for difficult conversations regarding valuation to a future date when the company is a more mature business.

Debt vs. Equity

Whereas an investor that negotiates the valuation of a startup company and invests via an equity financing receives an ownership stake in the startup company in the form of shares of stock, an investor investing via a convertible note instead lends capital to the startup company. The resulting debt instrument – the convertible note – is structured such that the capital borrowed either converts into shares of stock in connection with a future financing round at a lower price than that paid by future investors (see **Valuation Caps and Discount Rates** below) or is repaid upon maturity of the convertible note (see **Maturity Date** below); in effect, a convertible note acts as a prepayment on an investment in a future financing round while also providing for repayment of the investment if the future financing round does not occur prior to the maturity date. Convertible notes provide investors with the downside protection of holding a debt instrument (versus equity which is junior to debt in terms of priority of repayment) while also providing the potential upside benefit of the ability to convert the investment into shares of stock of the company upon a future equity financing or upon a liquidity event.

Accruing Interest

Convertible notes accrue interest over time; interest rates vary but a range of 4-8% annually is typical. This means that the amount owed to investors under the convertible notes will increase over time.

Discount Rates and Valuation Caps

As discussed above, convertible notes convert into equity of the startup company in connection with a future financing round. In recognition of a convertible note investor taking on more risk by investing at an earlier stage of the company's lifecycle, convertible notes typically include protective language that cause the convertible notes to convert into equity at a discount to the price/share paid by investors in the future financing round.

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[1] For more information on SAFEs, see a *Breakdown of SAFEs as an Investment Vehicle*.

This discount may be achieved in one of two ways.

First, a convertible note may include a prescribed conversion discount rate, effectively causing the note to purchase equity at a lower price/share than that paid by future investors. For example, if a startup company raises capital by issuing convertible notes with a 20% conversion discount rate and then subsequently raises capital in an equity financing round in which investors pay $1.00 for a share of stock, the capital invested in the convertible notes would convert into equity at an effective purchase price of $0.80/share. In such a scenario, whereas a new investor investing $100,000 in the equity round would receive 100,000 shares in return for its investment ($100,000/$1.00 = 100,000 shares), a convertible note investor that previously invested the same amount of capital would receive 125,000 shares of stock upon conversion of the note ($100,000/$0.80 = 125,000 shares). While conversion discount rates are negotiable and can vary, a range of 15-25% is typical.

Second, a convertible note may also include a “valuation cap” which is effectively a maximum valuation at which the convertible note will convert into equity of the startup company, irrespective of the valuation that is actually negotiated with investors in a future equity financing round. The purpose of a valuation cap is to protect against startup companies raising capital in an equity financing round at a higher than anticipated valuation which would result in the convertible note converting into fewer shares of stock. A convertible note with a valuation cap protects investors by putting in place a ceiling for the valuation amount that their note will convert upon, resulting in more shares being issued to the convertible note investor.

Maturity Date

Once a convertible note’s maturity date is reached, the convertible note becomes due and payable *together with all accrued interest* if an equity financing has not yet occurred and the convertible note has not been converted into stock. Occasionally, convertible notes will have terms that provide the investor to convert the note will be able to convert into equity at the option of the investor instead of needing to be repaid. While the maturity date can be negotiated, 2 years is quite typical.

How Does a Simple Agreement for Future Equity (SAFE) and Convertible Note Differ?

Whereas convertible notes represent debt on the books of a company, SAFEs are not technically debt instruments although they operate similarly to convertible notes, converting into equity in connection with a future financing. Unlike convertible notes, SAFEs do not have maturity dates meaning that SAFEs remain outstanding indefinitely. To learn more about SAFEs, please see a *Breakdown of SAFEs as an Investment Vehicle*.

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